

4.1 Economic development

Learning Outcomes

- Distinguish between economic growth and economic development.
- Explain the multidimensional nature of economic development in terms of reducing widespread poverty, raising living standards, reducing income inequalities, and increasing employment opportunities.
- Explain that the most important sources of economic growth in economically less developed countries include increases in quantities of physical capital and human capital, the development and use of new technologies that are appropriate to the conditions of the economically less developed countries, and institutional changes.
- Explain the relationship between economic growth and economic development, noting that some limited economic development is possible in the absence of economic growth but that, over the long term, economic growth is usually necessary for economic development (however, it should be understood that under certain circumstances economic growth may not lead to economic development).
- Explain, using examples, that economically less developed countries share certain common characteristics (noting that it is dangerous to generalize as there are many exceptions in each case), including low levels of GDP per capita, high levels of poverty, relatively large agricultural sectors, large **urban informal sectors**, and high birth rates.
- Explain that in some countries there may be communities caught in a poverty trap (poverty cycle), where poor communities are unable to invest in physical, human, and natural capital due to low or no savings; poverty is therefore transmitted from generation to generation, and there is a need for intervention to break out of the cycle.
- Explain, using examples, that economically less developed countries differ enormously from each other in terms of a variety of factors, including resource endowments, climate, history (colonial or otherwise), political systems, and degree of political stability.
- Outline the current status of international development goals, including the Millennium Development Goals.

Distinguish between economic growth and economic development

Economic growth is an increase in the real market value of goods and services produced by a country in a given period of time. Economic development, on the other hand, is not an easy term to define. It covers many areas of life. It is concerned with how economic growth can benefit people's living conditions through, for example, the provision of health-care services, housing, health and safety at work, and education and training. It is concerned with promoting a more equal distribution of income and wealth, and a more equitable society that provides equal opportunities for all, along with the promotion of human rights and freedoms and the elimination of absolute poverty and hunger. Economic development is concerned with increasing the welfare of humans and welfare is measured in many ways. The idea that a judgment can be made about individual welfare and society's welfare based only on a measurement of the real market value of goods and services is rejected.

What are the sources of economic growth in least developed countries (LDCs)?

Long-term economic growth is an increase in the productive capacity of a country. The level of potential output is determined by the quantity and quality (**productivity**) of the factors of production. Welfare and growth in most LDCs will not necessarily be increased by increasing the quantity of human capital. Increasing the size of the population might not lead to economic growth and even if it does it is more likely to reduce **income** per head. Many economists believe that the focus should be on improving the quality of human capital and **physical capital** in order to increase productivity. This is achieved through education to raise literacy and numeracy rates and training to give people the skills they need to earn an income. The provision of healthcare, good housing, and clean water also increases the quality of human capital leading to an increase in potential output.

Increasing the quantity and quality of physical capital leads to an increase in potential output. Physical capital includes the infrastructure such as transport networks, schools, hospitals, housing, factories, and commercial property. It also includes machines that are combined with labour to produce goods.

Investment in capital comes from **savings**. A relatively poor country has a high **marginal propensity to consume** and therefore a low **marginal propensity to save**. There are only limited funds available for investment in new capital and, without the necessary funds, research and development into new technologies

Subject vocabulary

urban informal sectors the part of the economy of a city where the economic activity that takes place is not taxed, monitored by any form of government, or included in any gross national product (GNP)

productivity the quantity of output per unit of input

income the payment received by the factors of production (e.g. wages paid to labour, rent paid to the owners of land)

physical capital any manufactured good that is used in the production of other goods and services such as machinery and buildings

savings income that is not spent or paid in tax

marginal propensity to consume the proportion of additional income that an individual spends on goods and services. $MPC = \frac{\text{the change in consumption}}{\text{the change in income}}$

marginal propensity to save is the proportion of additional income that an individual saves. $MPS = \frac{\text{the change in savings}}{\text{the change in income}}$

Subject vocabulary

foreign direct investment

cross-border investment, usually by firms, that involves the acquisition of assets in a foreign country. FDI can be the purchase of a minimum of 10% of the shares of a foreign company but also includes the creation of productive capacity.

tax revenue the income the government receives through the levying and collection of taxes

national income the sum of all income (wages, profits, rents, and interest) earned in a country in a given period of time

distribution of income how a country's total GDP is shared amongst its population

relative poverty a measure of poverty that relates to the average income earned in a country or region. Definitions vary but many governments define it as an income less than 50% of the median income.

external costs occurs when the production or consumption of a good creates a cost that must be paid by third parties

negative externalities occur when the production or consumption of a good creates costs that must be paid by third parties. The existence of negative externalities means that social cost is greater than private cost.

market failure when resources are not allocated or used efficiently

welfare loss the sum of the loss of consumer and producer surplus caused by market or government failure

gross domestic income the sum of all income earned by a country from the production of goods and services that occurs within its borders

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Glossary

degradation becoming worse in condition

malnourished ill/weak due to a lack of (good) food

is very limited. Attracting **foreign direct investment** is seen by some LDCs as a way of increasing the quantity and quality of capital thereby increasing economic growth.

And LDCs have limited funds available to invest in the infrastructure that would increase the potential output of the economy. Governments in low income countries receive relatively small amounts of **tax revenue**, limiting the amount that can be invested in transport systems, schools, and hospitals.

Certain institutions are necessary for economic growth. Political stability provides greater certainty and can increase business investment, including foreign direct investment. Banking services must be available to provide interest on savings and a source of funds for investment. A legal system must be in place so that contracts and rights of ownership can be enforced so that businesses can invest with confidence.

Model sentence: An increase in economic growth is dependent on the quantity and quality of the factors of production and the existence of institutions that reduce business uncertainty and increase the potential for investment.

Is economic development dependent on economic growth?

As the economy grows **national income** increases. How this improves welfare in the country depends in part on how the income is distributed. If the **distribution of income** is very unequal **relative poverty** will increase and only a very small percentage of the population will benefit. The lives of most people will remain the same.

Increases in income should increase tax revenue but increases in the welfare of individuals are dependent upon how the government uses the extra revenue. If it invests in better infrastructure – such as health services, education, and transport systems – it will help to encourage economic development, improve the welfare of the people and increase productivity leading to economic growth. Making health services and education available to more people will also lead to a fairer, more equitable society. If the government is corrupt and politicians steal lots of the money or if it is invested in the military, for example, the extra tax revenue will have much less impact on welfare, development, and long-term growth. Tax revenue could also be used to redistribute income more equally, thereby ensuring everybody benefits from the increase in national income.

There are **external costs** created by economic growth. There are **negative externalities** of production and consumption leading to **market failure** and **welfare loss** such as global warming caused by the burning of fossil fuels and **degradation** of land caused by excessive farming. Growth also leads to the reduction of non-renewable natural resources. Such growth is not sustainable because it negatively affects the ability of future generations to maintain an acceptable standard of living.

Explain the common characteristics of LDCs

The characteristics (in bold) shared by most LDCs are set out below.

LDCs have **low levels of gross domestic product** (GDP) per head. GDP is the market value of all goods and services produced in a country in a given period of time. GDP per head of a country is calculated by dividing GDP by the number of people living in the country. GDP per head equals **gross domestic income** per head (see page 41 for a full explanation of GDP). Low levels of GDP per head means that most of the population are relatively poor, often with many living in **absolute poverty**. Because income is distributed unequally there will be some people who earn much more than the GDP per head and those that earn much less. The income per head per year in the UK and France is about \$39,000 but in many countries such as Somalia and Ethiopia income per head is below \$500.

Low incomes mean many parents cannot afford to pay for an education for their children, pay for health services, or afford good housing. Many individuals are **malnourished** and suffer from ill health. LDCs tend to have relatively high child mortality rates and low literacy rates. With low levels of GDP in some LDCs the government does not have enough tax revenue to invest in infrastructure in order to increase the availability of health services, education, and good social housing.

Most LDCs have relatively **low levels of productivity**. Productivity is the measure of output per unit of inputs. Inputs are the factors of production. Labour productivity, therefore, measures the amount of output from a unit of labour (a worker). An increase in labour productivity occurs when more output is achieved from a unit of labour in a given period of time. Output per worker = total output / number of workers. Output per worker is relatively low in LDCs. The low level of productivity is caused by a lack of investment in **human capital** and **physical capital**. LDCs often lack the quantity and quality of capital necessary for sustained economic growth.

Many LDCs have **high birth rates** and **low life expectancy rates**. In the UK and France per year there are about 13 babies born per 1,000 of the population. Most developed countries have similar birth rates. In Somalia and Ethiopia the birth rate is over 3 times as high at about 42 babies born per 1,000 of the population. High birth rates mean that there are a very large number of people under the age of 15. These children have to be supported by the working population. This task is made more difficult because of the low life expectancy rates in most LDCs. In most developed countries the life expectancy rate is about 80 years. In LDCs it is much lower – in many, life expectancy is below 60 years.

Many LDCs have many **large informal markets**. The lack of government control and legal systems, and a lack of financial institutions such as banks, are some of the reasons why there are larger informal markets in LDCs than in developed countries. The informal sector is hidden from the government. Trade takes place unofficially. No tax is paid to the government either on income earned or goods bought. Transactions are not recorded and therefore are not included in GDP statistics. Official GDP statistics, therefore, do not reflect the true level of output.

In Africa the informal sector is an important source of employment and income. With such a high birth rate many countries do not create enough jobs in the **formal sector**, so unemployment and levels of poverty would be higher without the informal markets. In Nigeria it is estimated that about 15% of cross-border trade is in the informal sector.

Many LDCs have relatively **large agricultural and primary sectors** that provide a large proportion of export revenue. This is discussed in detail in on pages 243–48.

Explain how LDCs can differ

It is true that LDCs share many characteristics, but they are not all the same. Discussed below are the main areas in which they can differ.

A country's factor endowment is the quantity of land, labour, capital, and **entrepreneurship** that it can use to produce goods and services. Some LDCs have lots of factors but still remain relatively poor. In these cases countries have failed to exploit their factor endowments to their full potential. The reasons for this are varied.

Angola in southern Africa is a country with very large endowments of oil, diamonds, copper, and gold. Between 1975 and 2002 there was a civil war. Much of the infrastructure was destroyed and many 100s of thousands of people died. Without political stability and infrastructure the country was unable to exploit its resources. This highlights the impact that religious and ethnic conflict has on economic development and growth.

After 2002 the economy began to grow. In 2013 the economy grew by 8%. It has attracted much foreign direct investment in the past few years, which brings with it new more efficient technologies. This highlights the importance of the roles of political stability and business confidence for economic growth. Recent fast economic growth has increased GDP per head to \$6,000 per year, a lot less than in developed countries but a lot more than in other LDCs such as Burundi with GDP per head of about \$250. Burundi is a useful country to investigate as its circumstances highlight the reasons why some countries are very poor. The greater the religious and ethnic conflict the more difficult it is for the economy to grow. In many LDCs, such as Rwanda and Ethiopia, conflict has hindered economic development. This is of course not the case for all LDCs.

LDCs have a variety of political systems. Some are more stable than others and therefore they attract more investment. China is a one-party state which attracts a great deal of investment because it is regarded as stable, and this gives confidence to investors. The legal system governing business contracts also protects investment further, increasing business confidence. The Chinese government encourages inward investment and the economy has grown quickly over the last few decades. North Korea is a military dictatorship which operates a mainly **closed economy**. Very little international trade occurs. The state owns all enterprises, unlike China that has introduced **market reforms**. North Korea's economy has a very low growth rate and GDP per head is estimated to be about \$1,200. In China the GDP per capita is estimated to be about \$6,500.

The agricultural sector of LDCs is usually large and makes a big contribution to the GDP of the countries. Of course, some countries' climates are more favourable for the production of agricultural goods than others giving them a **comparative advantage** in the production of such goods. However, the agricultural share of GDP in LDCs is much greater than in developed countries.

For example, in 2012, the agricultural share of GDP in Sierra Leone was 57% and in Rwanda it was 33%. In the UK it was 0.8% and in the USA it was 1.2%. However, it is not always the case that LDCs have a large agricultural sector (Botswana's agricultural share of GDP is under 3%). It is important not to underestimate the importance of this sector for LDCs. The average agricultural share in LDCs is 28% of GDP. The average agricultural share of GDP of developed countries is under 2%.

Subject vocabulary

continued from page 250

absolute poverty occurs when people do not have enough resources to satisfy their basic needs

human capital this relates to the store of knowledge and the set of skills that a worker possesses which can be used in the production process. The higher the value of human capital the more productive the worker is. Human capital can be improved through investment in education and training.

physical capital any manufactured good that is used in the production of other goods and services such as machinery and buildings

formal sector employment and expenditure that occurs in legal markets where income and expenditure are a source of tax revenue

entrepreneurship the process of bringing together factors of production in order to produce goods or services with the aim of making a profit

closed economy an economy that is self-sufficient and does not trade with the rest of the world

market reforms changes made to the way in which markets operate that reduce or increase the level of competition

comparative advantage when a country, firm or individual is able to produce a particular good or service at a lower opportunity cost than other countries, firms or individuals

GDP per head in Bangladesh in 2012 was about \$750. It is one of the world's poorest countries. In 1950 agricultural share of GDP was 70% and manufacturing contribution was 4%. Over the years this changed and, in 2011, agricultural share of GDP was only 18% and manufacturing share increased to 30% of GDP.

A number of LDCs export tourism. For example, in 2011, the tourist sector accounted for 17% of GDP in Tanzania and 5.7% of the GDP in Kenya. Tourism is becoming a very important source of export and tax revenue for some LDCs.

Subject vocabulary

marginal propensity to consume the proportion of additional income that an individual spends on goods and services. MPC = the change in consumption divided by the change in income.

marginal propensity to save the proportion of additional income that an individual saves. MPS = the change in savings divided by the change in income.

human capital this relates to the store of knowledge and the set of skills that a worker possesses which can be used in the production process. The higher the value of human capital the more productive the worker is. Human capital can be improved through investment in education and training.

physical capital any manufactured good that is used in the production of other goods and services such as machinery and buildings

productivity the quantity of output per unit of input

direct tax a tax that is paid directly by an individual or firm to the government. For example income tax on wages and company profits.

infrastructure the physical systems of a country that includes transport and communication networks and sewage, water, and energy supply systems

Why are some countries caught in the poverty trap (poverty cycle)?

When incomes are very low households spend all of their income. Poor households must spend nearly all their income on satisfying their needs. Poor countries have a very high **marginal propensity to consume** and, therefore, a very low **marginal propensity to save**. A country that is very poor is not able to save and, therefore, there are few funds available for investment in **human capital** and **physical capital** – because there is little investment **productivity** changes very slowly. Investment is needed for economic growth, without it the economy cannot grow and incomes remain low. Income and expenditure are low, therefore **direct tax** and indirect tax revenue is low. The government has very little money to invest in **infrastructure** and with low levels of investment in infrastructure productivity remains low. The poverty cycle continues over generations unless it is broken by investment coming from outside of the country.

Model sentence: Low national income means that savings for investment are not accumulated and, therefore, productivity remains low leading to very slow rates of economic growth and low national income. This cycle of poverty has to be broken by inward investment.

Outline the Millennium Development Goals

In 2000, the United Nations agreed to a programme to achieve what are called the Millennium Development Goals by 2015. As discussed above, the economic development needs of LDCs are different, however the goals apply to all countries and are outlined in the illustration on page 253.

Source: World Family Organization.

The main goals are broken down into separate quantifiable targets. Progress towards these goals can be found on a number of websites. This information can be researched to gain an up-to-date assessment of progress so far.

Test your understanding of this unit by answering the following questions

- Describe the sources of economic growth in LDCs.
- Explain why economic development is dependent on economic growth.
- What are the common characteristics of LDCs?
- Explain why some countries cannot escape from the poverty cycle.

Millennium Development Goals - MDMs

Working the Millennium Development Goals at the Local Level and in the Family



*MDGs - Local Authorities - Family.
The Perfect Combination.*



ERADICATE EXTREME POVERTY AND HUNGER

Reduce by half the proportion of people living on less than a dollar a day and suffering from hunger.



IMPROVE MATERNAL HEALTH

Reduce by three quarters the maternal mortality ratio.



ACHIEVE UNIVERSAL PRIMARY EDUCATION

Ensure that all boys and girls complete a full course of primary schooling.



COMBAT HIV/AIDS, MALARIA AND OTHER DISEASES

Halt and begin to reverse the spread and incidence of HIV/AIDS, malaria and other major diseases.



PROMOTE GENDER EQUALITY AND EMPOWER WOMEN

Eliminate gender disparity in primary and secondary education preferably by 2005, and at all levels by 2015.



ENSURE ENVIRONMENTAL SUSTAINABILITY

Reduce by half the proportion of people without sustainable access to safe drinking water, achieve significant improvement in lives of at least 100 million slum dwellers, by 2020, and integrate the principles of sustainable development to reverse loss of environmental resources.



REDUCE CHILD MORTALITY

Reduce by two thirds the mortality rate among children under five.



DEVELOP A GLOBAL PARTNERSHIP FOR DEVELOPMENT

Develop a comprehensive commitment between the International, National and Local Level to develop partnerships to achieve the Millennium Development Goals.

Figure 80.1 Source: World Family Organization